

## ***Shari'ah Board's Role in Shaping Financial Performance: Evidence from the Islamic Banking Industries of Pakistan and Malaysia***

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### **Abstract:**

This study aims to investigate the impact of the Shari'ah Board (SB) characteristics on financial performance of Islamic Banks (IBs) a comparison between Pakistan and Malaysia. Shari'ah Board's characteristics are taken as independent variables i.e. Shari'ah Board size, Shari'ah Board Qualification of Islamic study Qualification of Fiqh, Cross-membership and reputation and expertise. A sample size of 6 Islamic Banks is used to test the hypothesis of the study from Pakistan and Malaysia for the period of 2008 to 2017 using the Generalized Least Square Method.

The result shows that Shari'ah Board characteristics have a significant effect on the financial performance of IBs in Pakistan and Malaysia. There is strong support for a significant relationship between SB cross membership, reputation and expertise. In addition, the SB size and qualification association with IBs performance is very important in improving the financial performance of IBs for both countries. Malaysia IBs applies the pro-active model that most extreme intervention of regulatory agencies.

**Keywords** Financial performance, SB characteristics, Islamic Bank, Pakistan, Malaysia

### **Introduction:**

*Shari'ah* board is the main pillar of *shari'ah* governance model. Each Islamic financial institution and Islamic Bank must appoint the *Shari'ah* board. The criteria for selecting *shari'ah* board must have qualification in terms of education like Islamic study and *fiqh* along with the experience in understanding the financial transaction of IFIs. For banks, the *shari'ah* board is appointed by central bank of the country. The *Shari'ah* board is the tool for the central bank to maintain the standards at operational level of the IFIs. According to bank of Pakistan the *shari'ah* board member must have at least 5 years relevant experience and fulfill Fit and Proper Criteria (FAPC). The tenure of the *shari'ah* board member is 3 years and can be reappointed and each Islamic Bank must appoint at least 3 *shari'ah* board members (SBP, 2018).

The study tries to investigate the empirical evidence from Pakistan and Malaysia that SB has an impact on financial performance of IBs because each country have different SGF model. According to SB characteristics there exist different types of *shari'ah* governance frame work based on the regulatory perspective and there are different *shari'ah* governance frameworks in different countries (see for further details Hasan Z, 2010).

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### **Shari'ah Governance Frame work in Pakistan**

Pakistan *Shari'ah* governance system is based on interventionist model, it is a third party institution involved for decision making and other *Shari'ah* issues which are related to Islamic finance, the highest authority for regulation in Pakistan is "State Bank of Pakistan" (Hasan Z, 2010).

In Pakistan, the *Shari'ah* governance framework for an Islamic financial institution is comprised of;

#### **Board of Directors (BOD)**

The board of directors has the responsibility to ensure that all operations and procedures in Islamic Banking Institutions (IBIs) with *Shari'ah* principles. The board of directors has to implement an effective mechanism for the functioning of the *Shari'ah* framework, *Shari'ah* board guidelines and compliance *fatawa*. The board of directors has the responsibility to appoint and approve *Shari'ah* board members. However, half annual meeting between *Shari'ah* board members and board of directors during a calendar year is held through video conference (SBP, 2018).

#### **Executive Management (EM)**

Executive management of Islamic Banking Institutions has the responsibility to implement *Shari'ah* framework which ensure that all procedures, product programs, contract agreements, process flows etc, are approved by the *Shari'ah* board. The executive management of IBIs is accountable for arranging employees training with *Shari'ah* compliance department (SCD), Moreover, executive managements also responsible to provide complete and relevant information to the SB for ruling or fatwa and decision for its proper understanding of proposal and products as per (SBP, 2018).

#### **Shari'ah Board (SB)**

All IBIs should have *Shari'ah* board members which comprise of at least three *Shari'ah* scholars who are appointed by the board of directors as defined by SBP (2018). The SBP appoints the SB members for a term of three (3) years IBIs in Pakistan.

The role of SB members to supervise all *Shari'ah* related matters like decisions, *fatwa*, ruling of IBIs and SB members are responsible and accountable for all the issued decisions and fatwa related *Shari'ah* matters.

*Shari'ah* board members are responsible for developing comprehensive *Shari'ah* compliance framework for all areas of operations of the IBIs in Pakistan. IBIs have proper approval from SB members for all products and services to be offered and launched. IBIs are accountable to submit all reports of internal *Shari'ah* audit, external *Shari'ah* audit. *Shari'ah* compliance reviews to SB for consideration to prepare compliance report for enforcement action and SB has an access to all records, documents and information, *Shari'ah* board is independent and has to objectively fulfill its duties (SBP, 2018).

#### **Resident Shari'ah Board Member (RSBM)**

The SBP has designated one *Shari'ah* board member as a RSBM for consultation with management. RSBM is responsible to oversee all procedures which are adopted for implementations resolutions, *fatwa* and pronouncements of the SB. IBIs are responsible to appoint the RSBM on full time basis, SBP allow to RSBM to give some time to academic activities related to the *Shari'ah*. Subsequently, SB with approval allows RSBM to join other IFIs as a *Shari'ah* board member maximum two IBIs, Moreover, RSBM is not allow to hold any position of administrative with other organization and institution other than IBIs where he selected or appointed as RSBM, RSBM should have submit quarterly report for approval to the SB (SBP, 2018).

#### **Shari'ah Compliance Department (SCD)**

*Shari'ah* Compliance Department (SCD) is one of the very important departments of IBIs. It plays an important role in the development of IBIs. It is headed by RSBM or other suitable experienced person which are appointed by SB. SCD works under the supervision and guidelines of SB where, SCD has some responsibility Conventional Bank. 1-Secretariat of *Shari'ah* Board 2-Conduit between Management and the *Shari'ah* Board. 3- *Shari'ah* Compliance Review 4- Enforcement of *Shari'ah* Audit Reports 5- Training of *Shari'ah* Compliance (SBP, 2018)

### Problem Statement:

*Shari'ah* governance is control systems to ensure that IFIs financing and investments are not in non *shari'ah* complaint avenues, further according to this system the IFIs have follow screening criteria before investments, which restricts their investors only in *shari'ah* complaint avenues. Keeping in views that there is apprehension that existence SB members may negatively impact on the profitability of IBIs, However, study tries to investigate that there is positive impact of SB characteristic on financial performance of Islamic Banks of Malaysia. So in this study, not only the SB's impact in Pakistan has been researched but a comparative impact has been studied for Pakistan and Malaysia.

The previous studies explored by conducting a study on the board of directors (expertise-Reputations, Board Size, Education Level etc.) on the performance of conventional banks. In this study I am trying to investigate and explore that is there any impact of *Shari'ah* board characteristics on the financial performance of Islamic Banks of Pakistan and Malaysian? Where the *Shari'ah* board characteristics are *Shari'ah* supervisory Education Level about *Fiqh* and Islamic Study, *Shari'ah* Board Size, Cross Membership, Reputation and Expertise.

This study aims to explore the significant influence of *Shari'ah* Board characteristic on the financial performance of Islamic banks. It is declared by the prior studies that *Shari'ah* board has a changing character which an important role in any institution. *Shari'ah* board had ruled and restricts *Shari'ah* rulings in the practices of Islamic banks.

### Literature Review:

This part of the study contains the literature of the prior studies related to the study where discussed the characteristics of the *shari'ah* Board; *Shari'ah* supervisory Education Level about *Fiqh* and Islamic Study, *Shari'ah* Board Size, Cross Membership, Reputation and Expertise. These are the *Shari'ah* board characteristics taken as independent variables of the study which aimed to be discussed in this chapter. Moreover, there are some external variable which relates the bank profitability taken as control variables based on the previous studies.

Rahajeng (2013) studied that the most relevant model of *shari'ah* governance for Islamic banking performance is the stakeholder model, they might be able to manage the trust to given to manager, and all parts of the firm. This trust may bring investment as the utilization of resources in aforementioned model based on lawful and ethical grounds such as the integrity and kindness create the balance in life when the rights and responsibilities should meet with Islamic value.

Matoossi & Grassa (2014) conducted a study on the impact of CG instruments on the execution of 77 greatest Islamic banks and 85 customary banks in both GCC nations and Southeast Asia nations from 2000 to 2009. They found a few vital contrasts between CG factors of the two sorts of banks. Besides, they took note that the board expense, President Duality and Chief age impact the execution of Islamic banks. They likewise focused on the imperative pretended by the SB in making the Islamic banks' esteem and execution.

Abdul-Rahman & Nor, (2017) used a sample of 40 Islamic banks for the period of 2008-2012 in Gulf cooperation council (GCC) by utilizing the stakeholder perspective. They employ the generalized least square methodology to explore the said association. They note that corporate governance mechanism of BODs such as ownership structure has no impact on IBs performance. Raman & Bukair, (2013) recorded the sample that the Islamic banks, which have extra SBs members and they have additional knowledge, expertise and experience in Islamic banking industry; they would provide more authentic information regarding Islamic principles. The result of regression analysis showed that there is positive significant relationship among the over all of SBs and CSR disclosure. In addition, the result provides more conformation of the implication of *shari'ah* rules, accountability, and full disclosure.

Nathan, (2010) have collected the data from 76 *Shari'ah* Supervisory Boards, 73 Boards of Directors, and 59 shareholders of IFIs in the GCC countries during 2009 (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and United Arab Emirates) through a questionnaire the empirical result indicated that SB execution is altogether and emphatically identified with SB gatherings and SB capabilities, yet adversely identified with SCD work, and that no factually noteworthy relationship exists between SB execution and authoritative

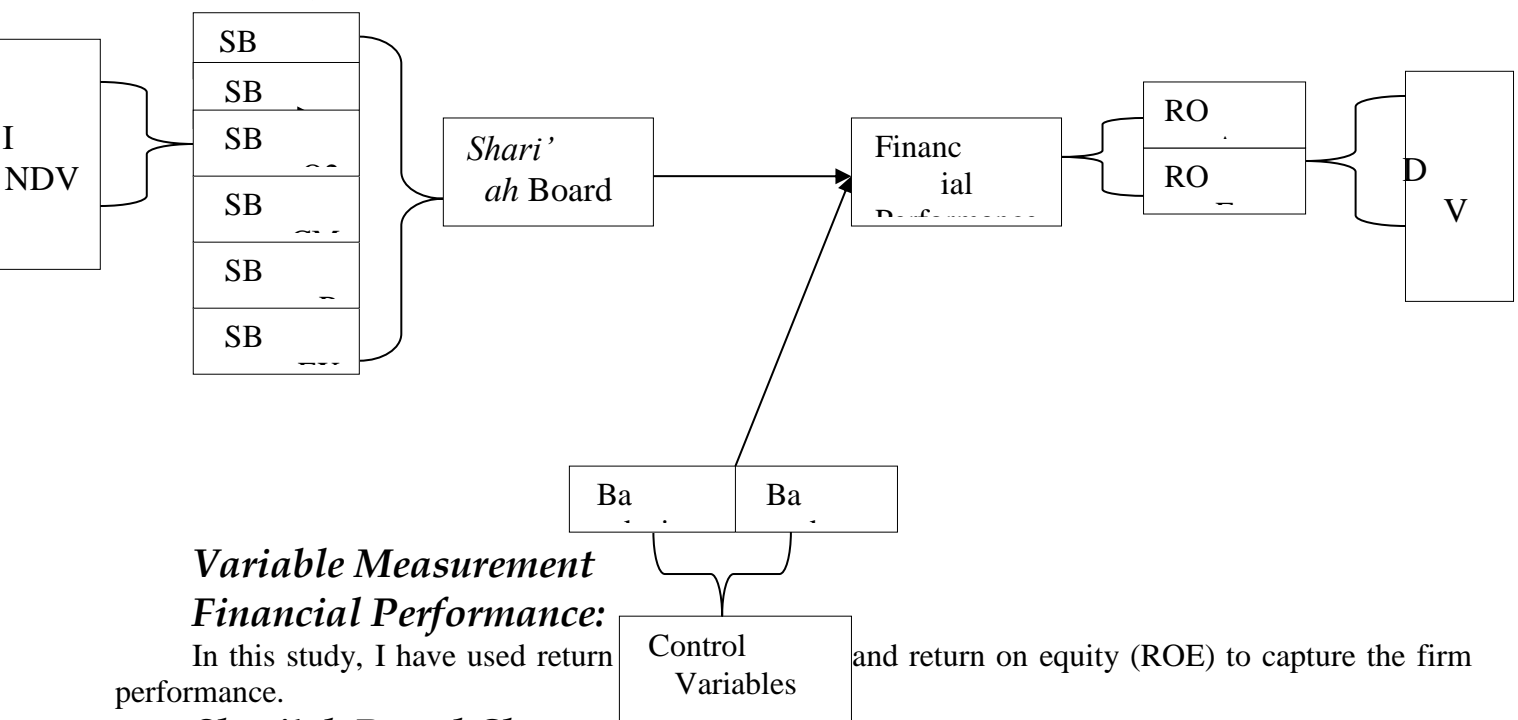
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structure. The aftereffect of the EVAL predictor shows a critical connection with the Performance variable since its centrality is under 0.10. Additionally, it has a beta of 0.612 which underlines the positive connection between the two.

Al-Saidi & Al-Shammari, (2013) have examined the relationship between board size, non-executive director, role duality, family directors and bank performance. Their sample was collected from nine listed Kuwait banks for the period 2006 to 2010. They also carried out that board size and part of non- execute directors have negative effect on Islamic bank performance, the result show that role have at the same time as positive and negative affects a bank's performance.

### ***Conceptual Framework***

Below process shows model and theoretical framework used in this study thesis. The model shows dependent and independent variables as well the control variables. The dependent variable Bank profitability which is indicated by its ratios which is return on assets (ROA) and return on equity (ROE). Independent variable is *Shari'ah* board which is characterized by its feathers which are; *Shari'ah* board size, *Shari'ah* board's qualification as Islamic studies and *fiqh*, *Shari'ah* board cross membership, reputation and supervisory board expertise. The selected control variable are; the bank age and size.



### ***Variable Measurement***

#### ***Financial Performance:***

In this study, I have used return and return on equity (ROE) to capture the firm performance.

#### ***Shari'ah Board Characteristics***

**Qualification of Islamic Study:** *Shari'ah* Scholar who have Islamic Study degree or Bs in *Shari'ah* Law, I have used (SBQ1) to capture the Qualification of the *Shari'ah* Scholars of Islamic study.

**Qualification of Fiqh:** *Shari'ah* Scholar who have Takhasus in *Fiqh* or LLM, I have used (SBQ2) to capture the Qualification of the *Shari'ah* scholars of *Fiqh*.

**Cross Membership:** *Shari'ah* Scholar who sit on other SBs, I have used (SBCM) to capture that sitting of SB members on other IFIs.

**Reputations:** Scholars who sit on board of *IFSB*, or *AAOIFI* & at least other international IFIs, I have used (SBR) to capture that SB member have membership of *AAOIFI*, *IFSB*, etc internationally or nationally.

**Expertise:** Scholars who have knowledge of Finance and Accounting or Finance degree, I used (SBEX) to capture that SB member have understanding of Finance and Accounting Knowledge etc. (Nomran, 2017; Arman, 2013; Hassan, 2017).

Following Mollah & Zaman (2015) the main explanatory variable used in this study is *Shari'ah* governance. Specifically, we include *Shari'ah* board size (*SB*), board meetings, experience, and education of *Shari'ah* board members as the proxy for *Shari'ah* governance.

### **Control Variables**

It is important to discuss the control variables other than focus variables that may influence the agency cost to overcome omitted variable bias (Davidson & Makinon 2004). Following are the control variables in this study because existing literature has been documented that these variables have influence on said association:

#### **Bank Size:**

In this thesis bank size is used as a control variable that may impact the financial performance, following previous study Zhou (2014), and Kishan & Opiela, (2000), Berger and Black, (2011), Mollah & Zaman, (2015), Musibah & Alfattani, (2014), and bank size will be measured by the logarithm of the total assets at the end of financial year of banks, Matoussi & Grassa, (2012); Hamza, (2016).

#### **Bank Age:**

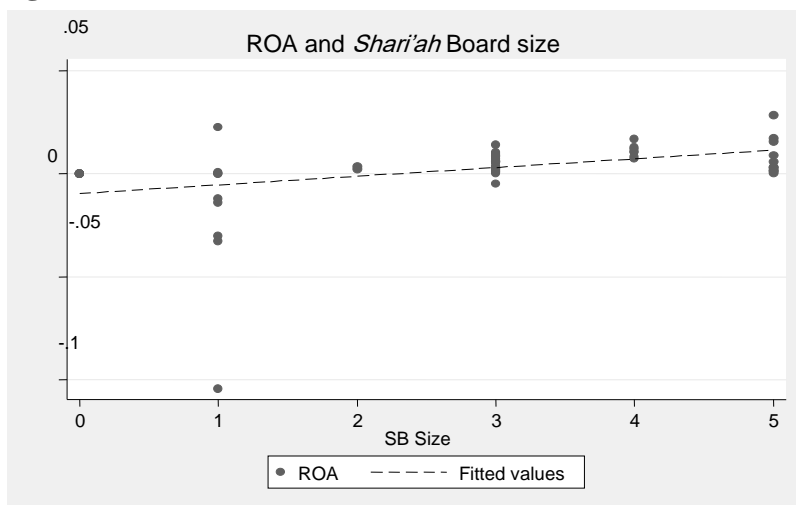
The bank age will be employed as control variable in this study; it may influence the bank performance, previous research is following Mollah & Zaman, (2015), Musibah & Alfattani, (2014). The bank age will be measured by the number of years since the bank was established as reported by Hamza, (2016), Matoussi & Grassa, (2012).

## **3. Results and Analysis**

Islamic Bank of Pakistan:

### **Correlation SB Characteristic with ROA**

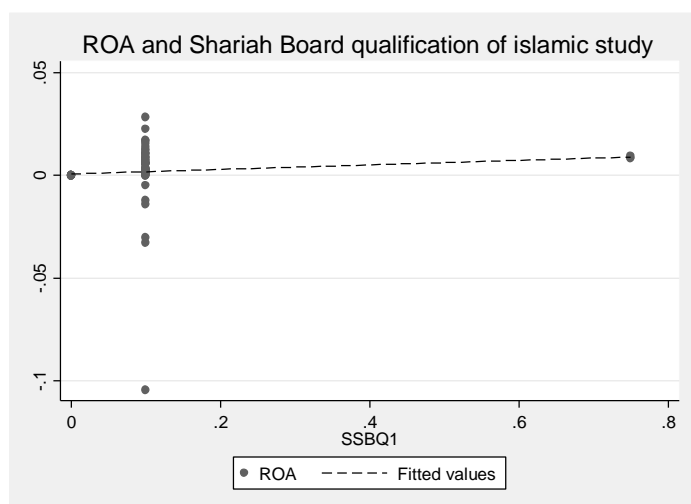
**Figure-1;** Scatter Plot of SB size and ROA



Above figure-1 is the scatter plot shows that when *Shari'ah* board size increased, there will be an increase the bank performance which is measured using ROA for the case of Islamic banks of Pakistan. The core reason behind its performance enhancement is sound clear that large Size of the *Shari'ah* Board will perform better having versatile experiences that will help a lot in making sensitive decisions for the betterment of the bank.

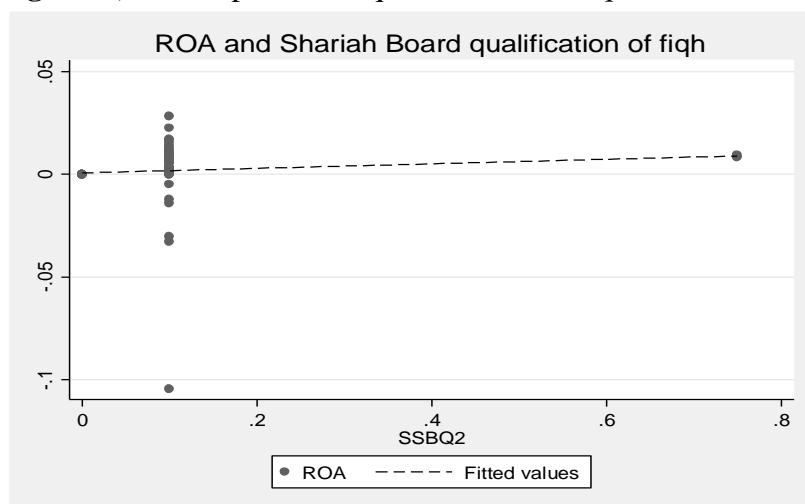
**Figure-2;** Scatter plot of SB qualification of Islamic Study and ROA

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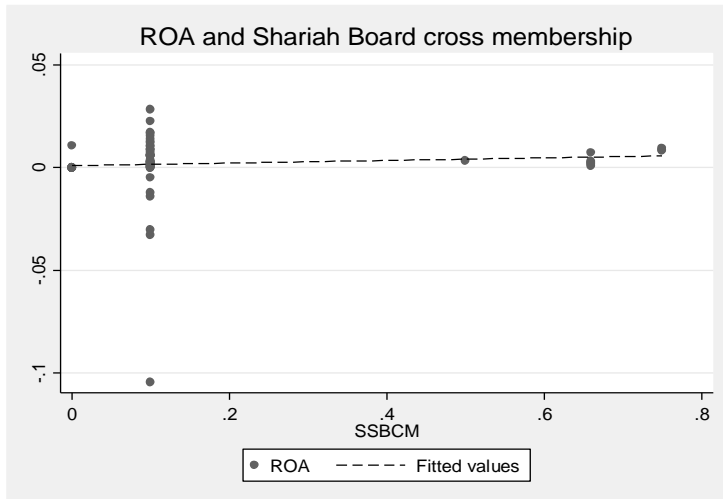
The above figure-2 predicts that if qualification of Islamic study of the SB is increased then ROA will also be increased. The reason for this increase can be presented as, more know how about the matter, more will be chances of its accuracy and righteousness. This is why the return on assets of these banks shows escalation with high qualification.

**Figure-3;** Scatter plot of SB qualification of *Fiqh* and ROA



Above figure-3 shows that if SB qualification of *Fiqh* increases then ROA also increases. Its trend to be seen from the line that change in value of the SB qualification make very little positive change in the ROA in the case of Pakistan. The performance increment reveals the fact that due to awareness and detail knowledge regarding the *Fiqh* and its different school of thoughts along with the Juirst interpretations, make the financial matter, issues and transaction more clear and easy to excute with full conformity with *Shari'ah* standards.

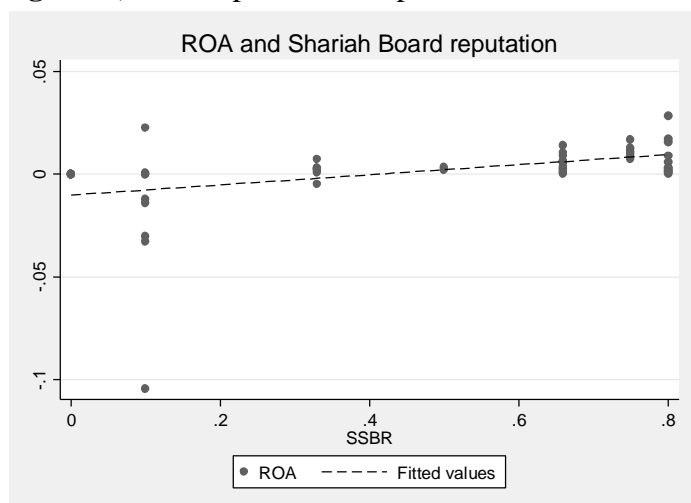
**Figure-4;** Scatter plot of SB Cross-Membership and ROA



The Figure-4 are justifies that SBCross-Membership does not make any significant change in ROA. The minute increase shows that this variable is not too much influential on the performance of the banks. Moreover, the cross membership may help a lot in different decision making regarding such financial matters which has already faced by any other bank earlier.

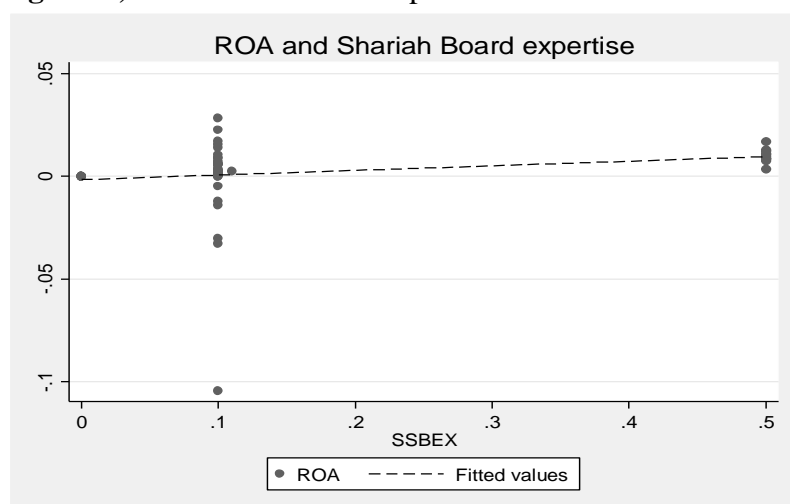
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**Figure-5;** Scatter plot of SB reputation and ROA



In the Figure-5 scatter plot indicates that if *SB* reputation increased then ROA will be increased, it can be seen through graph that *SB* reputation changemakes considerable changein the ROA. The reason of this increase is the accomplishment of national and International exposure of members across the globe.

**Figure-6;** Scatter Plot of SB Reputation and ROA



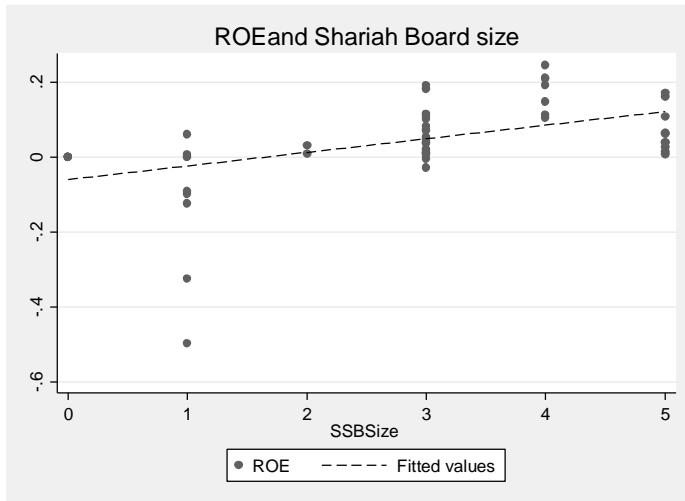
The figure-6 is the scatter Plot of the SBExpertise and ROA, it can observed that SB expertise make postive changes in ROA.

The reason behind is that it incorporation and excution of different new, innovative ideas in order toaccelerate the growth of the bank. So, the expertise of the members play a vitol in ensuring the performance escalation at all.

### **Correlation of SB Attributes With ROE**

**Figure-1;** Scatter Plot of SB Size and ROE

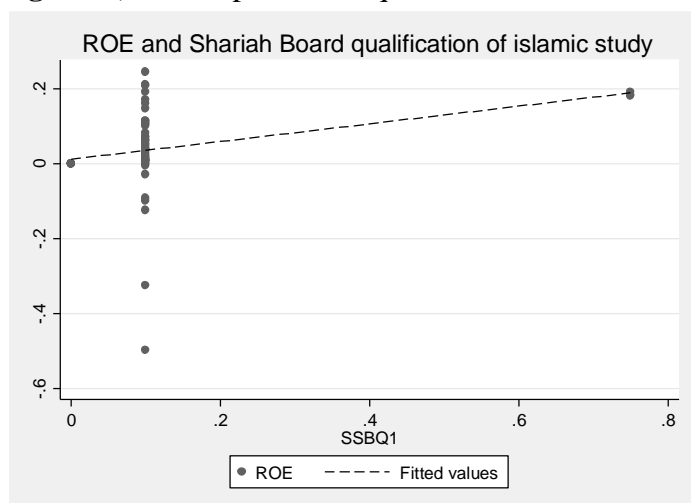




The above figure-1 is the scatter plot that predicates that when *Shari'ah* board size increased, that will increase the ROE. Here, the increase in *SB* size is met with an increase in ROE, for the case of Pakistan. The reason for this increase is the influence of larger size of *Shari'ah* board members and their goodwill may help in profitable transaction.

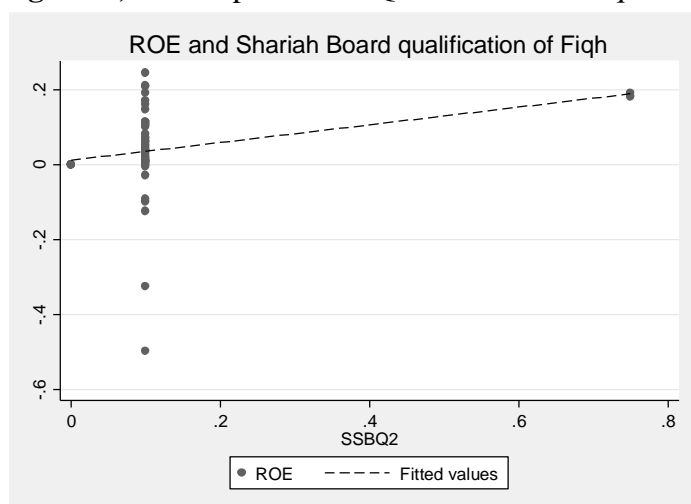
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**Figure-2;** Scatter plot of SB qualification and ROE



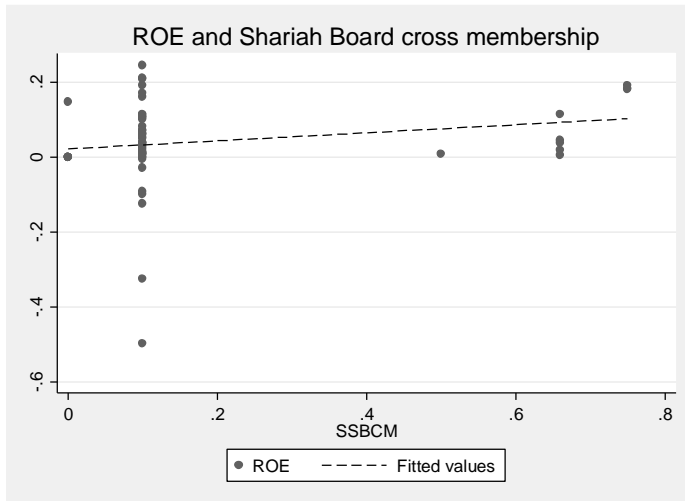
As above figure-2 shows that if the qualification of Islamic study increased then ROE will be increased. It means that SB qualification is correlated with bank performance which is ROE for the case of Pakistan. The core reason behind the increment is the effect of knowledge and public trust built due to high Islamic leads the system towards high profitability.

**Figure-3;** Scatter plot of SB Qualification of *Fiqh* and ROE



From the above figure-3 indicated that when SB qualification of *Fiqh* increased then ROE will also be increased. It means that SB qualification is correlated with ROE for the case of Pakistan. Return on Equity also increases because of qualification of *Fiqh* as this factor reflects the people's trust and satisfaction that transactions operating in the banks are streamlined with *Shari'ah* rulings and regulations.

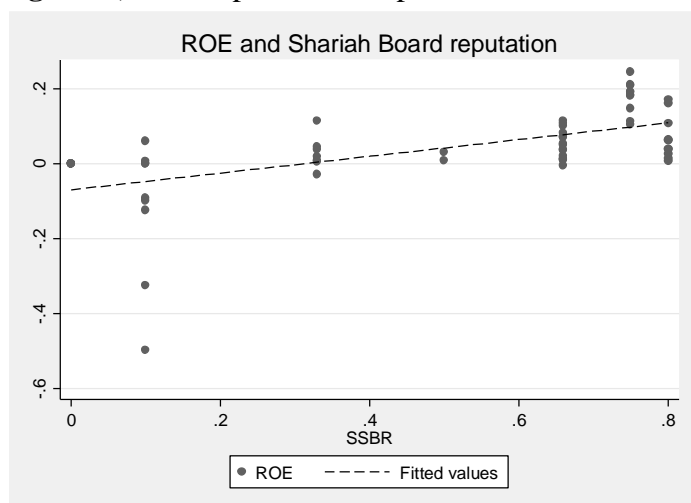
**Figure-4;** Scatter plot of SB Cross-membership and ROE



From above figure-4 it is clear that if SBCross-Membership will increase then ROE will also increase. It means that SB cross-membership has positively related with ROE. Return on Equity reflects increase; the reason is the inter-banks situational analysis that has been performed by membershasoffered their services in different Banks.

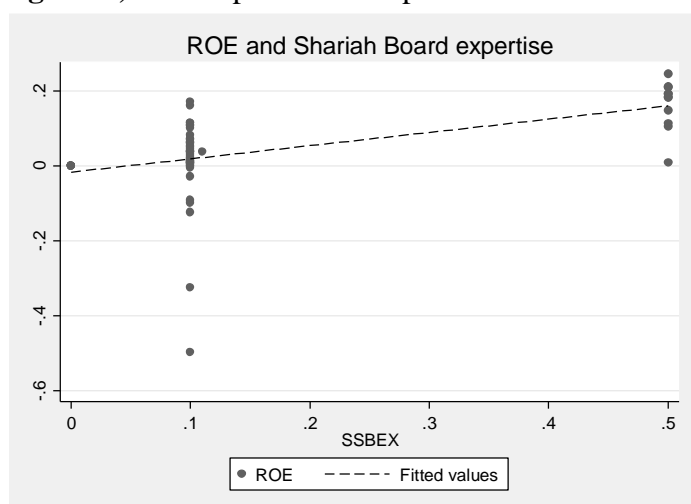
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**Figure-5;** Scatter plot of SB reputation and ROE



The above figure-5 shows that when Sharia board reputation increases, then it will make positive changes in ROE in case of Pakistan's Islamic banks. The reason for this increase is reputation of *Shari'ah* board members as high reputation and goodwill has positive impact on stakeholders.

**Figure-6;** Scatter plot of SB expertise and ROE



As result shown in above figure -6, it is noted that *Shari'ah* board expertise makes positive trend in Pakistan's Islamic banks return on equity. *Shari'ah* board expertise is shining sign of overall performance and potential of other team of the bank. That is why ROE shows growth due to expertise of members.

### **Conclusion:**

This study aims to examine the impact of *shari'ah* board characteristics on the performance of IBs in Pakistan and Malaysia, after analysis of regression and scatter plot tests of both countries separately. Below there is a comparison between all variables of both countries regarding *shari'ah* board characteristics which means that variables have a significant role in increasing the IBs' performance; this is a purpose of this research to check out those elements that may improve the financial performance of the IBs in both countries and which variable has more significant impact on financial performance.

Comparison Table 1

| Country  | ROA       | Bank size | Bank age  | SB size   | SB Q1     | SB BQ2    | SB BM     | SB BR   | SB EX     |
|----------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|---------|-----------|
| Pakistan | 1<br>C(P) | -.0944663 | .02       | .69       |           |           |           |         |           |
|          | 2<br>C(P) | -.002136  | .06       |           | -.0825116 |           |           |         |           |
|          | 3<br>C(P) | -.002136  | .06       |           |           | -.0825116 |           |         |           |
|          | 4<br>C(P) | -.005927  | .05       |           |           |           | .1        |         |           |
|          | 5<br>C(P) | -.0737515 | -.0048288 |           |           |           |           | .267241 |           |
|          | 6<br>C(P) | -.0105531 | .05       |           |           |           |           |         | .95       |
| Malaysia | 1<br>C(P) | -.0504905 | .01       | -.0082078 |           |           |           |         |           |
|          | 2<br>C(P) | -.0564632 | .01       |           | -.1676183 |           |           |         |           |
|          | 3<br>C(P) | -.0538662 | .00       |           |           | .2        |           |         |           |
|          | 4<br>C(P) | -.0536571 | .01       |           |           |           | -.3935324 |         |           |
|          | 5<br>C(P) | -.0613504 | .01       |           |           |           |           | .2      |           |
|          | 6<br>C(P) | -.05537   | .01       |           |           |           |           |         | -.1060791 |

This is comparison table of the impact of SB characteristic on financial performance between Pakistan and Malaysia,

In the above table *Shari'ah* board size (SB size) p value (0.000) and coefficient value (.6934046) shows that large *Shari'ah* board size has significant impact on performance in Pakistan compare to Malaysia, in Malaysia *Shari'ah* board size p (0.703) has insignificant impact on ROA it mean that size of *shari'ah* board don't matter in Malaysia.

*Shari'ah* board Qualification of Islamic study (SBQ1) p value (0.0758) highly insignificant and its coefficient value is negative in Pakistan that mean it has no impact on IBs return on asset. In case of Malaysia *shari'ah* board qualification of islamic study (SBQ1) p value (0.051) has insignificant and coefficient value ( -.0825116) which has negative relationship with ROA, it means that qualification of

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Islamic study has no impact on ROA in both countries and the reason is that SBQ1 has insignificant impact on ROA and it decreases ROA. ROA is generated on bank size in terms of assets and branch network While SBQ1 variable has concern with banking policies, products and operations.

In case of Pakistan same results are presented which is *Shari'ah* Board Qualification of *Fiqh* and in case of Malaysia. However, SBQ2 p value (0.014) has significant impact on ROA and it increases ROA. While it decreases bank size in terms of assets and branch network. SBQ2 variable has concern with banking policies, products and operations. SBQ1 can have impact on them but not on bank assets, how they are being used to get more returns depends upon bank management.

SBCM (*Shari'ah* Board Cross Membership) p value (0.310) has significant and positive impact on ROA which simply means that if board members have more than one banks membership, then they can of more experience of other banks policies and decisions forget organization more profitable in case of Pakistan but In case of Malaysia SBCM p value is highly insignificant its means that cross membership improve the performance of IBs, it is suggested that Pakistan adopt the SBCM policy of the Malaysia, They can help that bank to develop such products in which bank assets can be used in such a way to generate more profits on them.



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